

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of
ERNEST W. AND ALTA M. KETTENHOFEN }

Appearances:

For Appellants: Louis J. Propper, Public Accountant

For Respondent: Burl D. Lack, Chief Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Ernest W. and Alta M. Kettenhofen against a proposed assessment of additional personal income tax in the amount of \$215.88 for the year 1955.

Ernest W. Kettenhofen (hereafter "appellant") was a retail used car dealer, doing business as Ketty Car Co., during the year 1955. Typically, when appellant sold a car, he received a down payment consisting of cash or trade-in, or both, and the balance due was evidenced by a conditional sale contract which, in addition to the net cash price of the automobile, included a finance charge,

Many, but not all, of these contracts were transferred to finance companies. Most of the conditional sale paper so transferred was assigned, with recourse, to the Meriwether Investment Co., Ltd. In return, appellant received a portion of the unpaid balance of the purchase price plus a portion of his share of the finance charge. The portion of the purchase price retained by Meriwether was credited to an account titled "Withhold." After the customer had made a designated number of payments on the car, the amount in the "Withhold" account was paid to appellant. Similarly, the retained portion of appellant's share of the finance charge was credited by Meriwether to an account titled "Reserve." Any amount by which this "Reserve" account exceeded 10 percent of the total outstanding contracts

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was distributed to appellant, These accounts, commonly known as dealer reserve accounts, were held by Meriwether to secure appellant's obligations on the assigned contracts, the full performance of which he had guaranteed by the terms of the assignment. In the case of default on a contract, Meriwether charged appellant's dealer reserve accounts with the unpaid balance of the contract,,

Under appellant's method of accounting, all business expenses were accrued, as were those sales which were not discounted through a finance company. In 1955, he recorded his income from assigned conditional sales paper on the accrual method, including the amounts withheld by the finance companies in gross income. For tax purposes, however,, appellant's 1955 return reported such income on the cash basis, excluding therefrom amounts which had been credited to appellant's dealer reserve accounts but had not yet been received. This method of reporting was consistent with the practice appellant followed in earlier years. Bad debt deductions were claimed on the 1955 return for the amounts actually charged against appellant's dealer reserve accounts because of defaulted contracts, plus an amount that had been credited to a bad debt reserve account. This bad debt reserve related solely to sale contracts which had not been assigned to a finance company.

The Franchise Tax Board determined that the amounts withheld by the finance companies constituted income to appellant at the time such amounts were credited to appellant's dealer reserve accounts,

In Commissioner v. Hansen, 360 U.S. 446 [3 L. Ed. 2d 1360], the United States Supreme Court held that when accrual basis taxpayers, engaged in the sale of vehicles, sell installment paper to finance companies which withhold a portion of the purchase price of the installment paper as security for the performance of the dealers' obligations, crediting the same to dealer reserve accounts, the amounts placed in such accounts constitute accrued income to the dealers at the time the withheld amounts are entered on the finance companies' books. Subsequent cases following Hansen clearly establish that the Court's reasoning applies not only to amounts withheld from the dealer's share of the basic purchase price but also to amounts withheld from the dealer's share of the finance charges. (Shapiro v. Commissioner, 295 F.2d 306, cert. denied, 369 U.S. 829 [7 L. Ed. 2d 794]; General Gas Corp. v. Commissioner, 293 F.2d 35, cert. denied, 369 U.S. 816 [7 L. Ed. 2d 783].)

Section 17561, subdivision (a), of the Revenue and Taxation Code provides that "Taxable income shall be computed under the method of accounting on the basis of which the

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taxpayer regularly computes his income in keeping his books." Under respondent's regulations, a taxpayer whose business consists of selling merchandise must use the accrual basis unless he is authorized to do otherwise, (Cal. Admin. Code, tit. 18, reg. 17561, subd. (c)(2) and reg. 17601(a).) Further, respondent's regulations provide, in part, that a taxpayer using the accrual method of accounting, in computing business expenses shall also use the accrual method in computing items affecting gross income from his trade or business. (Cal. Admin. Code, tit. 18, reg. 17561, subd. (c)(iv)(a).) Appellant did use the accrual method in recording both business income and expenses on his books. He cannot be considered to have been on the cash receipts and disbursements method for tax purposes even though he may have reported certain income items on that basis, (See Appeals of Stanley H. Dettner, et al., Cal. St. Bd. of Equal., May 28, 1963.)

Appellant contends that the conditional sale contracts were not sold to the finance companies, that his customers made their loan arrangements with the finance companies and that, in effect, the finance companies then made loans to him. Nothing in the record before us supports such a contention. Indeed, a copy of a conditional sale contract submitted at the hearing of this matter establishes that it was assigned, with full recourse, to the Meriwether Investment Co., Ltd., by E. W. Kettenhofen three days after the conditional sale agreement had been entered into between the customer and Ketty Car Co., on November 5, 1955. (See also Commissioner v. Hansen, supra, 360 U.S. 446, 460, 461 [3 L. Ed. 2d 1360], which rejected a similar contention.)

Since appellant was an accrual basis taxpayer, the Hansen case and others cited above support respondent's conclusion that the amounts withheld by the finance company constituted income to appellant at the time they were credited to his dealer reserve accounts,

Appellant argues in the alternative that his dealer reserve accounts should be considered to be a reserve for bad debts, the additions to which were properly deductible. This argument is unacceptable for several reasons. The Revenue and Taxation Code provides for the deduction of any specific debt which becomes worthless within the taxable year or, in lieu thereof (in the discretion of the Franchise Tax Board), for the deduction of a reasonable addition to a reserve for bad debts. (Rev. & Tax. Code, §17207, subds. (a)(1) and (c).) It is clear that, with respect to losses on the contracts assigned to finance companies, appellant elected to use the specific charge-off rather than the reserve method. Furthermore, appellant has not shown that his dealer reserve accounts bore any reasonable relation to a proper reserve for bad debts.

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Finally, appellant has **not**, to our **knowledge**, met any of the **requirements** for the **use** of the bad debt reserve method as set out in the Franchise Tax Board's regulations. (See Cal. Admin. Code, **tit. 18, reg. 17207(d).**)

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and **good cause** appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Ernest W. and Alta M. Kettenhofen against a proposed assessment of additional personal income tax in the amount of \$215.88 for the year 1955, be and the same is hereby sustained.

Done at Sacramento, California, this 27th day of October, 1964, by the State Board of Equalization.

<u>Paul R. Leake</u>	Chairman
<u>John W. Lynch</u>	Member
<u>J. Pauland</u>	Member
<u> </u>	Member
<u> </u>	Member

Attest:

 Secretary